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James M. Davis
President

APR 1997
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April 10, 1997

Minerals Management Service
Royalty Management Program
Rules and Procedures Staff
P.O. Box 25165, MS 3101
Denver, Colorado 80255-0165

Re: MMS Proposed Rulemaking - Crude Oil Royalty Valuation

Gentlemen:

ARCO Western Energy (AWE) is an oil and gas production company located in the State of California. We produce crude oil from three Federal leases located in Kern County and two Federal leases located in Los Angeles County, California. We have reviewed the proposed rulemaking and have several very serious concerns about the proposed royalty valuation methodology based on index pricing using Alaska North Slope crude oil.

ARCO Western Energy is a unit of the Atlantic Richfield Company, a company that buys, sells and refines crude oil. However, ARCO Western Energy does not supply crude oil for refining to any ARCO company. As such, ARCO Western Energy operates as a "non-integrated" company.

However, since we are part of an integrated company that both sells and purchases crude oil, the proposed rulemaking would require us to establish the value of the oil by using the index valuation method discussed in Section 206.102(c)(2). This method will establish value at a much higher level than realized by the producer. Currently, California pipeline barrels are being priced by the market below the value determined by the methodology prescribed by the proposed rulemaking. This is a condition that the producers of crude oil in the state of California cannot control; we do not establish the price for our oil. Due to the lack of an efficient transportation system within the San Joaquin Valley, the market value for an incremental barrel of California crude is the Mid-continent market price minus the transportation tariff on the All-American Pipeline. This market establishes the price for California barrels in much the same way that the market for any commodity is established by its Minerals incremental price. This is the value that ARCO Western Energy is able to realize for its crude oil production. Yet, based on the proposed rulemaking, this will not be the value upon which AWE will pay for royalty barrels. This value will be based upon an ANS West Coast price that is at import parity. Analysis of crude prices undertaken by AWE have determined that the difference is approximately $1.00 per barrel. AWE will be forced by the new rule to employ the index pricing methodology, even though this is not the basis upon which we are able to realize value for the crude. Simply stated, this rulemaking will require us to pay royalties based on a price far in excess of that actually realized by ARCO Western Energy.

ARCO Western Energy is a producer of crude oil, and as such, we do not set the price we receive for the oil we produce. We gain no benefit or higher price for our crude because we are a unit of an integrated company. We are competing at "arms length" in a market with non-integrated producing companies. However, under the proposed rulemaking. these other non-integrated companies will not be required to determine value based on the index pricing methodology. These other companies, ***our direct competition***, will be allowed to use the gross sales price methodology which will put ARCO Western Energy at a distinct competitive disadvantage. These companies are no different than ARCO Western Energy, yet the proposed rulemaking will require us to use the index pricing methodology and pay royalties based on higher valued barrels; a higher value not realized by ARCO Western Energy. This methodology will cause ARCO Western Energy to become competitively disadvantaged.

Higher royalties associated with artificial crude prices will affect our business decisions regarding future development of these government properties. We will develop resources on properties where we can earn the best shareholder return on our investment. Properties which are burdened with royalty payments established by artificial prices not realized by the producer will not be as attractive for future development. As such, the proposed rulemaking could have a detrimental effect on the total revenue realized by the government.

The effect of the proposed rulemaking will be counter to recent Federal Government actions promoting and encouraging development of existing federal leases. Specifically, the Heavy Crude Royalty Relief Rule and Stripper Well Royalty Relief Rule enticed operators to invest millions of dollars of capital with the understanding that there would be an opportunity to recoup the investment. Our investment strategies were based on the conditions of the lease agreements and the royalty determination in place at the time of investment. Our investment strategy in federal properties would have been much different had the proposed rulemaking been in effect at the time of the investment. We are very concerned that past investments will not pay out if royalty is calculated by the proposed methodology.

AWE has increased spending to develop federal properties as a result of the royalty relief/reduction. Increased spending by major firms such as AWE has helped stimulate the local economy. New jobs and additional activity in the service and supply industries result from increased spending. New jobs and increases in work translate to more taxes being paid to all levels of government. This benefit to the economy is in jeopardy if development on federal properties is affected by the proposed rulemaking.

ARCO Western Energy encourages the MMS to carefully consider the impacts of the proposed rulemaking. We believe that the proposed rulemaking is detrimental to industry and the government and suggest the current method of determining royalty should be retained. As an alternative to the proposed rulemaking, we suggest that the federal government could take its crude production "in-kind" where the government could manage the resource to the best of its ability.

In summary, ARCO Western Energy is very concerned about the proposed rulemaking. The proposed rulemaking would require ARCO Western Energy to pay royalties on revenues not received, provide an advantage to our direct competitors, and potentially affect the future development of federal properties operated by ARCO. We trust that these comments will be given serious consideration as the proposed rulemaking will have a significant adverse economic impact on our current and future operations.

If you have any questions or need additional information, please don't hesitate to contact me at (805) 321-4000.

Sincerely,

James M. Davis
President

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